

hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

*Example (5).* In 1956 A dies; and, while his executor, C, is carrying on the business, the claim against B becomes worthless in 1957. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim on behalf of the estate, or create or acquire it in connection with a trade or business in which the estate is engaged, the loss is sustained as a proximate incident to the conduct of the trade or business in which the estate is engaged at the time the debt becomes worthless.

*Example (6).* In 1956, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business and since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

**§ 1.166-6 Sale of mortgaged or pledged property.**

(a) *Deficiency deductible as bad debt—*

(1) *Principal amount.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. See § 1.166-3.

(2) *Accrued interest.* Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income.

(b) *Realization of gain or loss—*(1) *Termination of amount.* If, in the case of

a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

(c) *Basis of property purchased.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss upon the subsequent sale is the fair market value of the property at the date of its acquisition by the creditor.

(d) *Special rules applicable to certain banking organizations.* For special rules relating to the treatment of mortgaged or pledged property by certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 595 and the regulations thereunder.

(e) *Special rules applicable to certain reacquisitions of real property.* Notwithstanding this section, special rules apply for taxable years beginning after September 2, 1964 (and for certain taxable years beginning after December 31, 1957), to the gain or loss on certain reacquisitions of real property, to indebtedness remaining unsatisfied as a result of such reacquisitions, and to the basis of the reacquired real property. See §§ 1.1038-1 through 1.1038-3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6814, 30 FR 4472, Apr. 7, 1965, T.D. 6916, 32 FR 5923, Apr. 13, 1967]

**§ 1.166-7 Worthless bonds issued by an individual.**

(a) *Allowance of deduction.* A bond or other similar obligation issued by an individual, if it becomes worthless in whole or in part, is subject to the bad debt provisions of section 166. The loss from the worthlessness of any such bond or obligation is deductible in accordance with section 166(a), unless

such bond or obligation is a nonbusiness debt as defined in section 166(d)(2). If the bond or obligation is a nonbusiness debt, it is subject to section 166(d) and § 1.166-5.

(b) *Decline in market value.* A taxpayer possessing debts evidenced by bonds or other similar obligations issued by an individual shall not be allowed any deduction under section 166 on account of mere market fluctuation in the value of such obligations.

(c) *Worthless bonds issued by corporation.* For provisions allowing the deduction under section 165(a) of the loss sustained upon the worthlessness of any bond or similar obligation issued by a corporation or a government, see § 1.165-5.

(d) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any bond or similar obligation reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471-5.

**§ 1.166-8 Losses of guarantors, endorsers, and indemnitors incurred on agreements made before January 1, 1976.**

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness

of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of § 1.166-5.

(c) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956.